Cost of debt consultation
Water 2020
Ofwat
21 Bloomsbury Street
London WC1B 3HF

17th October 2016

Dear Ofwat

Re: Consultation on the approach to the cost of debt for PR19

Overall, we are supportive of the changes proposed in this consultation. We think that this proposal is a good response to the recommendations of the PAC, and an incremental improvement in the economic regulation regime for the UK water industry. The way that Ofwat are seeking to introduce debt indexation seems to be a measured and balanced attempt to ensure a fair deal for customers, and we are supportive of the choice of Option 3.

We think that the proposal for linking debt to inflation indexes in question five is economically sound, but unnecessary in practice, and could to be too complex. There is a danger that such a mechanism could increase risk rather than reduce it, and lead to unintended consequences for both companies and customers.

We think that the proposals for the cost of equity are sensible in principle. We interpret them as a refinement of the approach to risk that Ofwat took at PR14, and see the proposals as consistent with the general direction of travel represented by menu regulation, ODIs, and risk-based-reviews. All of these things seek to allow companies taking greater risks to earn higher rewards (and vice-versa), and this is generally a good principle for economic regulators to pursue.

The other thing that we think is worth considering, is to have some kind of ‘dead band’ for movements in the cost of debt. We understand that the determination for Thames Tideway includes such a mechanism. This idea would lead to an adjustment mechanism that was more stable and simpler to operate, but would still work to reduce risk to customers and companies by neutralising large changes in the cost of debt.

Our responses to the questions you specifically raised in your consultation attached as an appendix.

As ever, please do not hesitate to contact me if you have any queries.

Yours sincerely

Tim Charlesworth
Head of Economic Regulation
Affinity Water

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Appendix – specific questions

Q1 Do you agree that the cost of debt allowance should be set on the basis of a notional capital structure and notional cost of debt for all companies as opposed to being based on the actual capital structure and debt costs of each company?

Yes, for the reasons set out in the document, we think this is the correct approach, and gives the correct incentives to companies.

Q2 We do not propose to introduce a specific benefit sharing arrangement for companies with securitised capital structures. Do you agree with this approach?

Yes, for the reasons set out in the document.

Q3 Do you agree to the introduction of indexation for the allowance for the cost of new debt?

Yes, option 3, the indexation method proposed (linked to an index or relevant benchmark) for the cost of new debt allowance is a sensible approach. This should reduce the forecasting error allowed for when estimating the cost of new debt as part of each price review. The detail of how the mechanism would work though is of significant importance.

There are some important considerations that should be taken in to account when designing the mechanism:

- Less frequent issuers (mainly the smaller companies) are unlikely to borrow funds throughout the regulatory period. A prudent approach for these less frequent issuers is to raise debt and lock in to long term rates (to mirror investment time horizons) upfront based on a known cost of debt versus the amount allowed for in the regulatory cost of capital. Having an indexed cost of new debt allowance exposes the companies and customers to further risk that the index could fall or rise after the debt has been raised. To mitigate this, companies could put in place interest rate swaps to match the regulatory cost of debt index but this further increases the cost of debt and complexity. It would be sensible if the indexation mechanism was designed to allow for companies to mitigate this risk for both them and customers once all funding for the AMP was completed.

- There are additional ‘cost of carry’ implications for raising debt in advance. In the current methodology these can be calculated and understood based on a fixed allowed cost of new debt for the AMP. The expense from cost of carry applies to all companies, small or large. The indexation approach (and the existing PR14 cost of debt approach) does not consider cost of carry that results from a prudent liquidity and interest rate strategy that customers would expect from a water company. You can argue that companies could use floating rate bank debt prior to securing long term finance but the leaves them exposed to movements in rates –the risk that they are looking to mitigate and should be responsible for.

- Moving to a CPI/CPIH WACC is already a significant change of its own which impacts the calculation of cost of debt. This change in regulation which has already been consulted on is far more significant in terms of providing legitimacy in the price control

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process. It does however bring additional risks for companies in how they will adjust their debt profiles to manage this basis risk for both embedded and new debt. These should be considered when setting the cost of debt mechanism for PR19.

- Could changes in the methodology for the allowed cost of new debt lead to less variation between companies on their cost of debt decisions? Companies could become solely focused on the mechanics of the index and how to track this which over time will lead to convergence. Variation in companies' approaches to raising debt in order to drive the most efficient cost of debt lower is reflected in the current embedded cost of debt and therefore customer bills. It's this ability to offer such variation in the type and maturity of debt that makes the sector attractive to credit investors.

- We are a long term infrastructure business funding long term assets. Cost of debt should reflect this where the funding decisions are efficiently made.

Q4 Do you agree that indexation of the new debt allowance should have an end of period adjustment?

An end of period adjustment for the difference between the forecast and realised cost of new debt would be our preferred approach. As set out in the consultation paper, this would allow for bill profiles to remain unchanged until they can be set again as part of the following price review. This allows companies to use all levers available to them at each review period, along with netting off any negative and positive variances to maintain a stable bill profile which appeals to both customers and the companies.

Q5 Do you agree to an adjustment to the inflation estimate to reflect out-turn inflation and so mitigate inflation forecast error for new debt only?

Customers currently bear the inflation risk through current bills and future bills through indexation of the RCV (both linked to RPI soon to be CPI/CPIH). Companies and their shareholders bear the other side of the inflation balance taking the equal and opposite risk on inflation. It's this explicit inflation linkage, which has always been one of the key attractions of the sector to investors.
When it comes to actual cost of debt, companies use their mix of nominal debt (fixed or floating) and inflation linked debt to further adjust their exposure to inflation. Companies looking to completely de-risk this, would fully RPI link their debt with those looking to achieve more inflation exposure electing to issue more debt on a nominal basis.

It seems that passing a decision around cost of debt inflation linking back to customers through a further inflation adjustment does not seem sensible and seems to question the existing "real" approach to economic regulation.

Secondly, the inflation forecast error applies to both cost of embedded debt and new debt. So it does not seem consistent to only apply it to new debt as the potential to outperform on embedded debt would still apply (depending on a company's actual cost of debt and the mix of RPI linked and nominal they have elected to have). But the original concern still applies, truing up for inflation differences between forecast and actual for cost of debt, moves away from the concept of real economic regulation.

Overall, we feel that this proposal is based on sound economic principles but, in reality, the operation of it would be so different to the practical ways in which companies raise debt, that it is

just as likely to increase risk for companies as to decrease it. Given the level of complexity that this proposal brings to the regulatory regime it seems that the potential disbenefits outweigh the benefits, so we feel that Ofwat would be well advised not to implement this proposal.

Q6 Do you agree that we should leave companies to develop their own risk company specific risk mechanisms on a voluntary basis for the 2019 price review and we should not mandate a company specific risk sharing mechanism?

Yes companies should be left to develop their own company specific risk mechanisms on an voluntary basis for the 2019 price review including cost of debt. Companies can consider their own circumstances based on the final mechanism for cost of debt that Ofwat decide to use, and look to build something specific for them which has support from customers.

The difficulty lies in where Ofwat decides that what has been proposed by a company or companies is not adequate and then looks to mandate a sharing mechanism for companies or the industry at a later date.

Q7 What are the potential advantages and disadvantages of a menu based approach to the cost of equity, compared with the approach adopted by Ofwat at PR14?

PR14 ensured that the return to shareholders was linked to companies' ambition and subsequent performance.

The risk based review process allowed companies to put forward ambitious plans in order to achieve enhanced status and additional rewards/benefits that come with this.

This combined with the introduction of company Outcome Delivery Incentives and the totex menu approach meant that companies were incentivised to bid their best and final offer. This was reflected in the RORE ranges across the sector. This targeted approach ensures that companies set out ambitious plans and then are required to deliver on them. It would be sensible for this process to be continued and improved through PR19.

The menu based approach to cost of equity seems to duplicate many of the aspects of PR14 which seemed to work well.

If a menu based approach were to be implemented there would need to be clear guidelines around what is considered to be Leading/Ambitious/Standard/Basic so that companies and their Boards could properly asses their position.